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Economic Conditions
Governmental Finance
United States Securities

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General Business Conditions

THE momentous victories of the past month, and the tremendous offensives that are cutting into German territory, resources and manpower from both East and West, have had little reflection in domestic business. In previous periods when the news from Europe supported hope of early victory the tendency was for markets to weaken in anticipation of reduced war demands, and for people to think and talk about cutbacks and problems involved in shifts to peacetime work. Now there is more reason than ever before for believing that the end of full-scale war in Germany is at most only a few months away, but opinions as to the effect on the economic situation have changed. The Washington authorities have made it plain that munitions schedules, expanded according to the decisions made late in 1944, will be held at maximum figures until war in Europe actually ceases. Also, they are insistent that cutbacks at that time and throughout the war with Japan will be of small proportions; and they have made known that troops moving to the Pacific from Europe will be largely re-equipped, leaving the bulk of their weapons and vehicles behind.

The business situation is dominated by this expansion in the war program and by the pressure to keep the war effort at the maximum. In the industries new war orders have created new demands for labor and materials, which have led to new measures to concentrate manpower in critical war work and to new restrictions on the use of materials. The steel position especially is tight, with the War Production Board reporting that requirements rated as essential for the second quarter are 24 per cent above the expected production. "Iron Age" says steel orders within the last few weeks reached the boiling point, and they have fallen off since only because mills have filled their books.

An increase in aluminum production has been ordered and zinc will be put back under allocation April 1, as lead recently was. Rosin is expected to be allocated for the first time, and probably linseed oil. Military takings of leather are being increased. The War Manpower Commission describes the labor shortage by saying that although plants making critical items gained 120,000 workers in January, they needed 181,000 more at the end of the month, with more plants added to the "must" list.

An industrial situation of which these are the outstanding features obviously has little room for increase of civilian production and even talk of reconversion is at a standstill. But while the indications are plain that supplies of civilian goods will become smaller rather than larger, consumers' incomes are at an all-time peak, and will be maintained as long as war expenditures are maintained. Stimulated by both factors, a rush to buy is on, which on top of the record-breaking Christmas trade has lifted department store sales in the latest weeks reported to levels 22 and 24 per cent, respectively, above a year ago.

Most interpretations of the rise in stock prices consider it also, at least in part, an effect of the expansion of the war program and the revision of V-E Day expectations. Commodity prices have been edging upward; the advance has been slow and small, but the generally accepted price indexes have been making new highs by fractional margins.

The Outlook

This brief summary depicts a business organization driven at top speed by almost unlimited war demands, and urged to still greater speed; further encroachments on civilian activity; and continuing evidence of the pressure of the money supply created by the Federal deficit. Nor is much change immediately in prospect. The unknown element in the outlook is whether developments after victory in Europe will be as most people now seem to expect, or whether greater cutbacks than are now talked of will be possible, when the time comes to measure stockpiles and current production of munitions against the requirements of the Japanese war. Few people outside the

procurement agencies can know all the facts. Many Washington observers, however, have expressed their belief that surpluses will permit cutbacks earlier and to a greater extent than recent official statements have indicated.

If this is so its significance is twofold. The first point is that business should take the possibility into account, and not proceed too boldly on the assumption that present industrial conditions will last indefinitely. The conservative policy is to keep inventories and finances in order, to be prepared for contract terminations and settlements, and to have postwar plans ready as far as is consistent with meeting war needs.

The second point is that there is a line beyond which stockpiling of munitions for future use becomes unwise, if it leaves insufficient materials for proper maintenance and repair of facilities classed as part of the civilian economy, but vital to the war effort. Such stockpiles borrow from the present at the expense of the future. The policy of bearing hard on civilian enterprise extends even to such an essential as railway maintenance and replacement, at a time when railway facilities are being strained to the utmost. For the second quarter of this year the War Production Board reduced the requisitions of the Office of Defense Transportation for carbon steel for transport equipment (chiefly rails, track accessories, freight cars, and automobile replacement parts) from 1,527,000 tons to 1,065,000. The allotment for the first quarter was 1,255,000. The broad question is whether limitations on civilian supplies in this and similar cases may not impair productive efficiency to the point of impeding the war effort. It is not a matter of catering to civilian comfort or privilege, but of balancing one war requirement against another and giving proper weight and proportion to each.

The Rise in Government Bond Prices

The pronounced rise in government security prices and resulting decline in yields since the 6th War Loan drive in November-December is a development of outstanding significance, affecting the entire investment situation. Leading the move have been the 6th War Loan 8/10-year 2 per cent bonds and 21/26-year 2½s, the former rising to a premium of over 1¾ points over the offering price of par, at which the yield is reduced to 1.74 per cent, and the latter reaching a premium of over 2 points, at which the yield is cut to 2.37 per cent. Other Treasury issues have fallen in line, as indicated by the following table comparing prices and yields of representative issues on February 26 and October 31 before the latest bond drive:

Treasury Bond Prices and Yields to Call Date
(Fractional prices in thirty-seconds)

	Oct. 31, 1944		Feb. 26, 1945		Change	
	Price	Yield	Price	Yield	Price	Yield
2 — 5 years:						
1¾s 6-15-48	101.14*	1.34%	101.26	1.19%	+0.12	—0.15
2s 12-15-51/49	101.21	1.66	102.18	1.45	+0.29	—0.21
5 — 10 years:						
2s 9-15-52/50	101.07	1.77	102.14	1.54	+1.07	—0.23
2s 12-15-54/52	100.00*	2.00	101.27	1.74	+1.27	—0.26
10 — 15 years:						
2½s 3-15-58/56	103.25	2.13	105.24	1.92	+1.31	—0.21
2¼s 9-15-59/56†	100.18	2.19	102.27	1.97	+2.09	—0.22
20 years and over:						
2½s 3-15-71/66‡	100.00*	2.50	102.06	2.37	+2.06	—0.13
2½s 9-15-72/67	100.14	2.47	102.27	2.33	+2.13	—0.14

* Offering price — 6th War Loan issue. † Not eligible for commercial bank purchase prior to Sept. 15, 1946. ‡ Not eligible for commercial bank purchase prior to Dec. 1, 1954.

For the first time since the financing of this war began there has been a major departure from the pattern of interest rates established by the Treasury. Speculation is rife as to whether the Treasury will take advantage of the lower rates to change the terms and character of the offerings that will comprise the 7th War Loan, expected in the late Spring.

Establishment of the "Treasury Yield Curve"

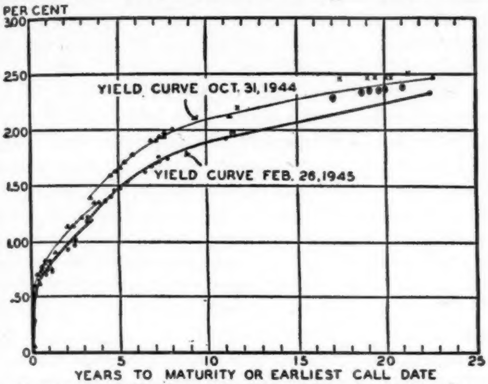
It will be recalled that in October 1942 the Treasury announced that rates on the war financing would be stabilized on a scale running from ⅜ per cent for 90-day bills and ⅞ per cent for 1-year certificates up through 2 per cent for 10-year bonds and 2½ per cent for long-term bonds, with new issues eligible for investment of commercial bank deposits limited to a 10-year maximum. In the market parlance, the chart line running through these various rates and maturities has come to be known as the "Treasury yield curve".

The program contemplated use of the facilities of the Federal Reserve Banks both for supplying the market with the funds needed to assure generally low interest rates for government borrowing, and for maintaining the pattern of rates for the different maturities in accordance with the yield curve determined upon. Since 1942 the rate at the low end of the curve has been pegged at the ⅜ per cent buying and selling rate maintained on bills by the Federal Reserve Banks. Yields on other outstanding government securities, while not frozen in the manner of bills, have been closely controlled by the buying and selling operations of the Reserve Banks.

When the Treasury first announced its rate stabilization policy, the general feeling was that the problem would be to prevent interest rates from rising under the impact of the huge volume of government financing coming on the market. Few people expected to see interest rates decline.

Yet the latter is precisely what has been happening. In the diagram below, comparing

the curve of interest rates on Treasury fully taxable obligations at the end of February this year and before the 6th War Loan drive, it will be seen that rates have tended to break away on the down side, bending the curve downward in the middle and longer maturities.



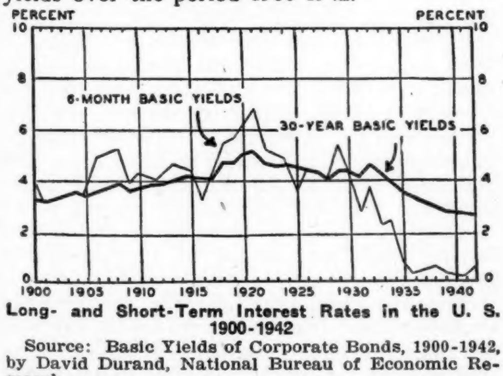
Treasury Fully Taxable Securities Available for Purchase by Commercial Banks. Yield Curves October 31, 1944 and February 26, 1945 Compared.

Break in curves distinguishes callable issues from fixed maturity issues. Long-term issues not available for bank purchases designated by X (October 31, 1944) and circled X (February 26, 1945).

Factors Influencing the Interest Curve

The full explanation of the forces now operating on the yield curve cannot be found in the events of the past few years only, but requires a longer perspective. As a starting point we must examine the origin of the interest rate pattern which had developed and was adopted by the Treasury in the Fall of 1942. We have become so accustomed in recent years to the present great disparity between the long rate and the short, that we have perhaps come to regard it as a more or less normal condition.

Actually, this relationship is historically unusual. This is shown by the accompanying diagram comparing long- and short-term basic yields over the period 1900-1942.



Long- and Short-Term Interest Rates in the U. S. 1900-1942

Source: Basic Yields of Corporate Bonds, 1900-1942, by David Durand, National Bureau of Economic Research.

It will be seen that while the short rate in this comparison has fluctuated more violently than the long rate, it moved on the average in much the same plane (if anything a little higher) until the '30s. Many people forget that for a considerable period in the '20s Treasury notes sold at a higher yield than long-term Treasury bonds, and that when Treasury bills were first issued at the end of 1929 the rate of around 3.3 per cent was nearly the same as the long-term bond yield. Not until the early '30s did the present wide and persistent spread between long and short rates begin to develop.

Still more striking are the comparisons for Great Britain going back nearly 100 years, revealed in the following table from an article on "The Future of Interest Rates", by E. V. Morgan, in the December 1944 "Economic Journal" of the Royal Economic Society, as follows:

Comparison of British Long- and Short-Term Interest Rates

Period	Average Yield on Consols	Average Rate of Discount (3 mths. bills)
1849-1909	3.0	3.2
1910-1914	3.3	3.4
1915-1918	4.3	4.3
1919-1921	5.1	5.1
1922-1931	4.5	3.8
1932-1938	3.3	0.8
1939-1943	3.1	1.0*

* Figures for 1849-1938 are from, "The Short Term Rate and the Long Term Rate," by M. Kalecki, in Oxford Economic Papers, September 1940.

In these averages will be seen again the close correspondence between the long and short rate over an extended period — in this case 70 years. In Great Britain the first signs of a significant gap appeared in the '20s, followed by a widening in the '30s similar to that which took place here.

These illustrations emphasize the point made above, viz., that the present yield curve, with its long-continued and widespread disparities, is exceptional, if not unprecedented.

The reasons for the creation of the present unusual interest structure are to be found partly in the psychology of the times. The period going back before the present war has been one of great political and economic uncertainty, an atmosphere in which investors naturally seek liquidity and prefer short-term to long-term commitments. Many investors, still mindful of heavy bond market losses in the '20s and early '30s, have been reluctant to reach out again for the longer maturities. All this has tended to depress short-term rates compared with long.

The main cause, however, of the extraordinary rate gap, and one that has distinguished this period particularly, has been the dominating influence of the commercial banks in the market. Probably never before has this influence been so important. This has been due partly to the heavy movements of gold and partly to development of the technique of

money market management. In this country the huge gold imports of the '30s and early '40s flooded the banks with excess reserves and induced heavy purchases of government securities, thus driving down rates. In Great Britain the cheap money policies of the Government, adopted to facilitate debt conversion and to stimulate business, had the same effect. The chief point to be made, however, is that the commercial banks entering the market constituted a class of buyers which, in addition to sharing the prevalent distrust of the current low interest rates, were by tradition and from the nature of their liabilities predisposed in favor of short-term investments. The result was to intensify pressure on the short rates, driving them down relative to long rates, and thus bringing about the present rate pattern, which though unusual has become so familiar that we are almost forgetting that there ever was any other.

The Changing Attitude of Investors

Gradually, this partiality for short-term investments, founded partly on habit and partly on fear of rising interest rates, has tended to wane. As banks and other investors have gained confidence in the effectiveness of money market controls they have reached out to the longer maturities in order to get the higher yields. One of the forces spurring this on has been the generally low level of interest rates which has driven investors to seek more remunerative yields in order to maintain income.

As the tendency to lengthen investments grows, it should operate on the interest curve in two ways, (1) tend to depress the yields of the intermediate and longer securities as these securities come more into demand, and (2) tend to increase the yield of the shortest-term securities as investors bid less eagerly for new supplies coming on the market or sell what they have to shift into longer maturities. But since the short end of the Treasury yield curve is anchored down by the pegged ⅜ per cent buying rate for bills maintained by the Reserve Banks, the effect is a general lowering of the curve on this pivot, as indicated by the first diagram above.

Early signs of developing confidence in the stability of the rate structure appeared in the Spring of 1943 in a greater demand from banks for the medium-and long-term Treasury bonds. This demand was directed chiefly to the partially tax-exempt issues for several reasons. Those banks whose earnings were improving were becoming more conscious of a tax problem, and the partially tax-exempt issues had been selling out of line with the fully taxables by reason of doubts as to whether the Treasury might take some action that would impair their tax exemption value. Also, the Treasury had ceased to issue exempt securities, so that the prospect was one of steadily decreasing supply through retirement and refunding with fully taxable issues. The fact, however, that the demand for the partially-exempt issues was not confined to nearby maturities, but spread out into the longer bonds, appeared indicative of a growing assurance about the continuance of low interest rates.

During the first half of 1943 the Federal Reserve Banks sold around $1.4 billion of Treasury bonds to help meet the demands and keep prices from rising too rapidly. At the same time they were absorbing large quantities of bills offered by the banks from time to time in adjusting their reserve positions. In this way, Reserve Bank operations tended to stabilize the rate structure, restraining the tendency for rates to fall at the longer end of the scale and to rise at the short end.

In August 1943 the yield curve was tested again — this time at the short end — when the August issue of ⅞ per cent certificates jumped immediately to a premium reducing the yield to less than ¾ per cent, with the demand so insistent as to indicate a possible lowering of the rate. But the Treasury made larger amounts of certificates available instead of changing the rate.

Market Behavior Since 6th War Loan

The growing tendency to regard the longer bond maturities as just as safe as the shorter was encouraged just before the 6th War Loan drive from a number of sources. The announcement by the Presidential candidates of both major parties of their determination to maintain low interest rates for future financing and refunding of the government debt had a strong influence upon sentiment, leaving no doubt as to interest rate policy regardless of what party might be in power. Early in November came action by the British Treasury in discontinuing the sale of National War Loan 2½ per cent bonds of 1952/54 and offering in their place 1¾ per cent Exchequer bonds of 1950, which was widely interpreted as a move on the part of the British Government to lower interest rates in the British market. Further evidence of the changing investor attitude appeared during the Sixth War Loan drive in a reaching out to longer maturities, with many investors who had previously bought notes turning to the 2 per cent bonds, and others buying the 2½s instead of the previously favored 2s.

Since the Third War Loan the Treasury has excluded banks from subscriptions to war loan offerings (except for limited amounts in relation to time deposits); but their indirect participation has bulked large through the purchase of outstanding securities and loans against the new issues. This exclusion of the

banks from direct subscription has also resulted in large bank purchases of the new issues after each drive. Following the close of the Sixth War Loan, this buying both generated and was accelerated by apprehension that in the next war loan the rate curve would be lowered. While this bank interest centered in the 2% bonds the 2½s moved just as strongly on smaller volume into savings banks, insurance companies, trust funds, and state and municipal funds.

The Question of Future Policy

All this, of course, raises important questions of policy with respect to the future of interest rates. Looming ahead in the near future is the necessity of making decisions with respect to the terms and conditions of the 7th War Loan. Thus far the Treasury has given no official indication of its intentions, either as to rates or as to direct offerings to banks. It has been noted, however, that the monetary authorities have made no serious effort to oppose the decline in rates and alteration of the interest rate structure that has been taking place. While the Federal Reserve Banks have in the past two months reduced their holdings of government securities of more than 5 years' maturity from $918 million to $812 million, or by $106 million, this decline is a mere drop in the bucket compared with the demand for issues of the medium- and long-term category. To what extent this is a matter of policy or a reflection of a scarcity of holdings of the popular maturities is not clear, since the Federal Reserve statements show no breakdown of security holdings by maturities beyond 5 years.

While the Government has been successful in keeping the general level of interest rates low despite the huge expansion of credit and currency called for by the war financing, control over the structure of interest rates is apparently another matter. For, as explained above, such control leads to the paradox that the more the public believes the Treasury can maintain the money curve, the more difficult it actually becomes to do so. Unless the Treasury adopts a policy of diminishing its offerings of short securities and increasing the supply of longer issues, the tendency of investors to shift from short to long maturities considered equally safe operates inevitably towards equalizing rates along the money curve. Since the short end of the interest curve, however, is held down by the policy of pegging the rate by unlimited Federal Reserve purchases of bills at the fixed price of ⅜ per cent, the effect, as investors lengthen their commitments, is to bring about a general lowering of interest rates along the whole curve. This tendency naturally is accentuated if the market suspects that future issues of securities of the desired maturities may be restricted.

Effects of Lower Rates

While a further lowering of interest rates would enable the Government to borrow more cheaply, the effect upon the incentive to save needs most serious consideration. As was well stated by Mr. Beaudry Leman, president of the Banque Canadienne Nationale, at the annual shareholders' meeting of that institution in January, "When the State is the largest borrower, low money rates are equivalent to an impost and are tantamount to a levy on the many forms of savings, such as life insurance, legacies, fixed interest-bearing securities, etc. To ransom savings is to discourage thrift and the consequences are not slow to become manifest." If savings banks and insurance companies are unable to get even the yields heretofore accepted as "wartime lows," they will have to pass on the reductions to the great masses of people who save through them. Already these institutions have had to cut substantially their rates paid on policies and accounts, and today these rates are at their all-time lows.

Especially in this period of great wartime expansion of money and credit we need to consider carefully the possible consequences of lowering still further the inducement to save. In the war bond drives the constant effort has been to effect the widest possible distribution of bonds to individuals in order to combat inflation. But the lower the rate of interest paid, the less financial inducement there is for the individual to save rather than spend. While it is true that the interest rates paid on war savings bonds have not been affected by recent market changes, the amount of purchases per individual is limited, and many investors prefer the straight coupon marketable bonds to the savings bonds, which must be registered and held to maturity in order to receive the maximum interest.

Nor can we be sure that the danger of inflation will end when the war is over. With a huge accumulation of liquid assets in the hands of the public, there will be need for continued efforts to get government securities out of the banks and into the hands of the people. To do this the interest rate must not be too low. The patriotic impulse, so large a factor in the purchase of war bonds today, will not then be present.

Finally, the higher and more artificial the levels to which bond prices are driven today, the more vulnerable the market becomes to disturbing fluctuations later on. While the ability of the Government to keep interest rates low during the war is generally conceded, the real test of the powers of money management will come in the postwar period. Much of the Government's success in controlling interest rates in wartime has been due to the widespread controls over prices, wages and

other economic conditions, submitted to willingly during wartime, but which the American people hope to get rid of as rapidly as possible. Although the announced policy of this and other governments is to maintain low interest rates after the war, that policy has yet to pass the test of experience.

The tendency wherever government controls are set up is to move constantly in the political rather than in the sound economic direction. In the case of war financing, there is always the temptation to take the easy way of cheapening the interest rate, which constitutes a hidden tax on the thrifty, rather than the politically less popular course of paying a rate that will induce saving and spreading the cost more widely over the great body of taxpayers.

Industrial Corporation Earnings

The outstanding feature of reports thus far issued by industrial corporations for the year 1944 is the further expansion in production and sales to meet the requirements of the war effort, to which approximately two-thirds of the output of American industry is now devoted. Despite curtailment in production of goods not considered essential to the war effort, and despite numerous cutbacks and cancellations of government contracts because of changing war demands, the total dollar sales volume of companies so far reported was the largest in history, exceeding the previous peak in 1943 by approximately 11 per cent.

There was a decline in margins of profit on sales, but net earnings were held up by the increase in volume and were stabilized by the high federal income taxes, so that net income showed only moderate changes. A tabulation of the reports of 715 manufacturing companies shows combined net income in 1944 of approximately $1,163 million after provision for tax and other reserves, compared with $1,123 million in 1943, an increase of 3½ per cent. About 53 per cent of the companies reported decreases in net earnings, however, against 47 per cent with increases. The 1944 earnings are subject in most cases to the renegotiation of government contracts, while the corresponding 1943 figures have been revised downward in numerous cases where renegotiations resulted in a greater reduction of earnings than had been provided for by reserves.

A majority of the reports show, in smaller margins if not in smaller earnings, the effect of continued advances in operating costs. The acute manpower shortage, widely commented upon in corporate reports for last year, and the employment of less experienced and less efficient workers, together with increases in wage rates and in costs of materials, supplies and services purchased, cut profit margins sharply in many lines. The adverse effect upon net earnings of rising costs against fixed selling prices, in "peacetime goods" as well as war material industries, was particularly

PRELIMINARY SUMMARY OF MANUFACTURING EARNINGS IN 1943 AND 1944

Net Income is Shown after Depreciation. Interest, Taxes, and Other Charges and Reserves, but before Dividends.—Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Net Income After Taxes 1943	Net Income After Taxes 1944	Per Cent Change	Net Worth, Jan. 1 1943	Net Worth, Jan. 1 1944	% Return 1943	% Return 1944
18	Baking	$ 21,987	$ 20,347	— 7.5	$232,348	$234,846	9.5	8.7
14	Meat packing	46,282	45,235	— 2.3	624,715	594,839	7.4	7.6
54	Other food products	51,039	64,340	+26.1	542,088	554,980	9.4	11.6
38	Beverages	31,642	38,936	+23.1	246,375	259,512	12.8	15.0
13	Tobacco products	49,646	47,565	— 4.2	483,770	497,998	10.3	9.6
33	Cotton goods	21,614	18,339	—15.2	239,507	248,254	9.0	7.4
39	Other textile products	32,997	32,746	— 0.8	334,619	359,701	9.9	9.1
17	Clothing and apparel	9,351	8,454	— 9.6	91,645	95,005	10.2	8.9
19	Leather and shoes	18,344	16,119	—12.1	208,140	212,610	8.8	7.6
16	Rubber products	47,116	49,400	+ 4.8	396,118	427,662	11.9	11.6
20	Lumber, wood products	6,552	7,768	+18.6	81,420	87,091	8.0	8.9
31	Pulp and paper products	30,939	30,655	— 0.9	402,798	414,408	7.7	7.4
30	Chemical products	113,303	125,530	+10.8	1,093,318	1,168,690	10.4	10.7
8	Drugs, soap, etc.	30,102	29,017	— 3.6	184,639	201,972	16.3	14.4
10	Paint and varnish	8,275	8,887	+ 7.4	119,042	120,040	7.0	7.4
16	Petroleum products	61,950	80,156	+29.4	757,831	805,555	8.2	10.0
21	Stone, clay and glass	28,144	26,020	— 7.5	333,438	348,884	8.4	7.5
27	Iron and steel	179,541	170,582	— 5.0	3,274,445	3,322,106	5.5	5.1
11	Agricultural implements	53,128	50,969	— 4.1	611,085	632,666	8.7	8.1
19	Bldg., heat., plumb. equip.	13,382	15,075	+12.7	163,982	169,594	8.2	8.9
24	Electrical equipment	55,952	63,260	+13.1	545,703	574,855	10.3	11.0
20	Hardware and tools	12,180	9,106	—25.2	72,880	77,417	16.7	11.8
58	Machinery	35,955	34,176	— 4.9	246,379	260,648	14.6	13.1
9	Office equipment	13,697	15,501	+13.2	130,342	133,304	10.5	11.6
65	Other metal products	77,765	79,017	+ 1.6	593,433	650,817	13.1	12.1
40	Autos and equipment	35,542	38,272	+ 7.7	256,369	282,755	13.9	13.5
8	Railway equipment	16,369	17,135	+ 4.7	164,047	165,169	10.0	10.4
47	Misc. manufacturing	20,255	20,291	+ 0.2	241,191	246,009	8.4	8.2
715	Total manufacturing	$1,123,049	$1,162,898	+ 3.5	$12,671,662	$13,147,387	8.9	8.8

marked where volume of sales was curtailed by cutbacks of government contracts, inability to obtain raw materials, or other causes.

Total net worth of the group at the beginning of 1944 aggregated $13,147 million, upon which the year's net income represented an average return of 8.8 per cent, compared with a 1943 net worth of $12,672 million and a return of 8.9 per cent. The returns shown by previous tabulations of similar though not identical groups of companies were 10.1 per cent in 1942, 12.4 in 1941, 10.3 in 1940, and 8.5 in 1939.

A preliminary summary by industrial groups for the past two years is given in the accompanying table. The tabulation does not yet include many of the largest companies in the automobile, aircraft, petroleum and other manufacturing industries, whose reports will be issued during the current month and will be included in our final summary in April, together with results in the fields of mining, trade, transportation, public utilities, service, and finance.

It will be seen from the summary that the number of industrial groups showing increases in net income was about equal to the number showing decreases, and that most of the percentage changes either up or down were within a considerably narrower range than in prior years. A major factor in this relative stability of net income was the high rate of excess profits taxes, which tends to offset to a large extent any increase or decrease in operating earnings. Income tax details now available for part of the group indicate that estimated reserves for 1944 federal taxes (normal tax, surtax, and excess profits tax, less 10 per cent postwar refund or debt retirement credit) were about 68 per cent of net income before taxes. This is somewhat lower than the 70 per cent average reserve in 1943, despite the fact that the 1944 rate on excess profits was 95 per cent against 90 in 1943. The overall tax ceiling remained at 80 per cent, however, and the moderate decrease in average tax reserves last year may reflect, among other factors and adjustments, possible over-reserves in 1943.

Longer-Term Earnings Trend

The longer-term trend of industrial corporation earnings is shown in the table below, which summarizes the Treasury Department annual "Statistics of Income" for all manufacturing corporations in the United States and our own annual tabulations of the published shareholders' reports of leading manufacturing companies. The percentage rates of return on net worth are pictured in the chart.

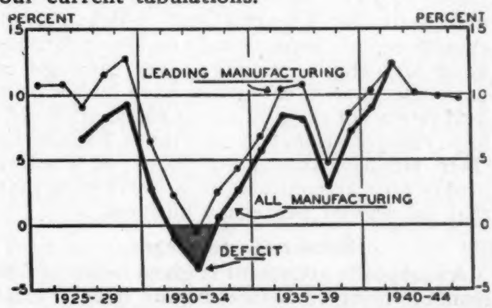
Our own annual tabulations, each covering the two preceding years, which are not based upon a "selected" list of companies but upon all for which figures are available at the time, do not contain exactly the same number of companies and therefore are not strictly comparable over a period of years.

Net Income of Manufacturing Corporations
(In Millions of Dollars)

Year	All Mfg. Corp. in the U.S.* Net Income aft. Tax	Net Worth Jan. 1	Per Cent Return	Leading Mfg. Corp.** No. of Cos.	Net Income aft. Tax	Net Worth Jan. 1	Per Cent Return
1925	$3,562	$ n.a.	—	1,205	$2,272	$21,306	10.7
1926	3,640	n.a.	—	1,271	2,470	22,875	10.8
1927	3,050	46,273	6.6	1,264	2,179	24,240	9.0
1928	3,935	48,050	8.2	1,245	2,927	25,341	11.5
1929	4,537	50,017	9.1	1,245	3,431	26,802	12.8
1930	1,424	52,695	2.7	1,226	1,851	28,963	6.4
1931	D-521	52,122	—1.0	1,025	550	24,051	2.3
1932	D-1,616	47,640	—3.4	1,096	D-103	21,758	—0.5
1933	237	43,976	0.5	1,144	523	20,765	2.5
1934	1,166	43,342	2.7	1,138	808	18,839	4.3
1935	2,122	38,152	5.6	1,193	1,322	19,820	6.7
1936	3,116	37,611	8.3	1,279	2,007	19,251	10.4
1937	3,069	38,467	8.0	1,410	2,481	23,067	10.8
1938	1,228	41,239	3.0	1,410	1,139	23,876	4.8
1939	2,946	41,260	7.1	1,440	1,938	22,916	8.5
1940	3,764	42,438	8.9	1,495	2,628	25,598	10.3
1941	5,493	44,163	12.5	1,420	3,216	25,870	12.4
1942	—	—	—	1,336	2,522	24,906	10.1
1943	—	—	—	1,321	2,496	25,187	9.9
1944p	—	—	—	715	1,163	13,147	8.9

* From Treasury Department annual "Statistics of Income". ** From National City Bank annual tabulations of published shareholders' reports. D- Deficit. n.a. Not available. p Preliminary and incomplete.

Because so many of the same large companies are included in the tabulations year after year, however, the percentage rates of return on net worth provide an indication as to the general trend of earnings. The annual tabulations have been presented in the April issue of this Letter in their present form, including net worth and rate of return, beginning with 1928. In order to show a longer base in the pre-depression period, the series recently was worked back to include 1925, 1926 and 1927, using the corporate reports from Moody's Manual and following the same method as in our current tabulations.



Annual Rate of Return on Net Worth of All Mfg. Corp. and of Leading Mfg. Corp.

In the five-year period 1925-29, the average annual return on net worth of these leading manufacturing companies was about 11 per cent, declining in the 1930-34 period (including one net deficit year) to an average of 3 per cent, recovering in the 1935-39 period to an average of 8 per cent, and increasing in the 1940-44 period — with a tremendous expansion

in volume of business — to an average of 10 per cent. For the entire twenty-year period, the average was about 8 per cent.

Although the rate of return shown by leading companies has tended to follow the same general trend as that shown by the official Treasury statistics for all manufacturing companies, there has been a spread of about 2 percentage points, on an average, between the two series up to the year 1941, when they came practically together. While the series have been regarded in the past as roughly comparable, they differ in many respects, two of which may be considered major causes of the much sharper rise in 1941 in the earnings of "all manufacturing corporations" as compared with those of leading corporations.

One important difference is that the Treasury statistics show "net income" as defined for tax purposes, and make no allowance for reserves for contingencies and postwar conversion resulting from the wartime expansion of industry that began in 1940. Although such reserves have for many years been widely used by accountants and business men, they are not legally permitted deductions from income in computing taxes. This causes "net income" as reported on tax returns to be correspondingly higher than that shown on published corporate statements.

A second important difference is that the great expansion in volume of general business since 1940 permitted large numbers of closely-held and smaller corporations, including "marginal producers" and those in receivership or reorganization, which file tax returns with the Treasury but issue no public statements, to increase their profits sharply, or to decrease their deficits (with the same effect on the combined totals), whereas many of the larger manufacturing organizations which publish regular reports were already making relatively good and stable earnings. Net earnings of nationally-known companies have in fact been held down not only by rising costs, price ceilings, renegotiation, and high taxes, but also by their publicly announced policy of limiting profits on war contracts to a lower rate than that on regular peacetime business.

Balance Sheet Changes

A composite statement is given below of 120 manufacturing companies having sales or total assets over $5 million. This shows that the 1944 expansion of total assets was the smallest in any year during the war period. Most of the increase took place in government securities, although cash and "other assets" (including postwar tax refund bonds) were also slightly higher. The rise in inventories was confined mostly to the tobacco companies. A small increase in gross plant and equipment was more than offset by depreciation reserves.

Composite Balance Sheet of 120 Manufacturing Companies with Sales or Total Assets over $5 Million

(In Millions of Dollars)

	December 31				
Assets	1940	1941	1942	1943	1944
Cash	$ 363	$ 348	$ 448	$ 546	$ 564
Government securities	47	138	271	392	458
Receivables, net	324	446	549	588	586
Inventories*	934	1,204	1,428	1,440	1,478
Total current assets	1,668	2,136	2,696	2,966	3,076
Plant and equipment	2,264	2,354	2,381	2,401	2,421
Less depreciation	1,031	1,083	1,135	1,202	1,263
Net property	1,233	1,271	1,246	1,199	1,158
Other assets	278	277	298	353	366
Total assets	3,174	3,684	4,240	4,518	4,600
Liabilities & Capital					
Notes payable	40	77	105	123	192
A/c pay., accruals, etc.*	178	264	514	500	470
Reserve for taxes	154	376	499	622	618
Total current liab.	372	717	1,118	1,245	1,280
Deferred liabilities	222	265	319	331	315
Reserves	96	118	143	181	198
Capital and surplus	2,484	2,589	2,660	2,761	2,807
Total	3,174	3,684	4,240	4,518	4,600
Working capital	1,296	1,419	1,578	1,721	1,796
Current ratio	4.48	2.98	2.41	2.38	2.40

* Includes advances on government contracts.

On the liability side, notes payable showed the largest increase of any year during the war period, due mainly to larger borrowing by tobacco companies. Capital and surplus continued to increase, though at a diminishing rate. Reserves (excluding depreciation) increased slightly, but at the end of 1944 were but 4 per cent of total assets.

Working capital again increased, and in the four years was built up by 39 per cent. Although the "current ratio" remained practically stationary at 2.40, government securities and cash alone were almost as large as total current liabilities.

This composite statement does not include many leading organizations for which balance sheets have not yet been issued, and the aggregates shown are of course not typical of all manufacturing companies, many of which have expanded several-fold during the war period and are in a much less liquid condition.

Two of the most important questions now facing business are the actual values that will be realized from the liquidation of inventories and receivables when government contracts and subcontracts are terminated, and the operating losses that may be sustained during the period of reconversion.

A substantial portion of the cash and other assets now carried as "current" must be recognized as having been "borrowed" temporarily from fixed assets, which during wartime operations have been wearing out faster than they could be replaced. Despite the funds spent by industrial corporations on plant additions needed in war production, the plant improvements and extensions postponed by the war continue to accumulate and must be made up when labor and materials again become available.

Not only in the case of large and old-established companies, but even more so with new and rapidly expanding enterprises, it is extremely important that a strong and liquid position be maintained in order to provide or attract the large amounts of capital that will be needed as soon as the war ends to finance active peacetime employment and normal long-term growth.

Problems of Philippine Rehabilitation

The unexpectedly rapid liberation of the Philippines has brought this country face to face with a problem which has had little or no public discussion during the war, and of which the bulk of the American people, it is safe to say, are but little aware. Now events have made it suddenly urgent. Broadly speaking, it is the problem of the future economic relations of a free and independent Philippine nation with the United States. Nominally settled by provisions embodied in the Independence Act of 1934 as amended in 1939, which provided for the independence of the Philippines July 4, 1946, the problem of economic relations has been revived and immensely complicated by the war and the Japanese occupation. Not only is the destruction caused by the war a factor unanticipated in 1934 or 1939, but more than three years of time has been lost during which, but for the war, the Filipinos could have been adjusting their agriculture and industry to prepare for forthcoming independence. Now, with the situation still chaotic, independence may be only months away. A Congressional Resolution has authorized President Roosevelt to proclaim the full independence of the Commonwealth as soon as the enemy is driven out and constitutional processes and normal functions of government established, — even before the 1946 date set by the Independence Act.

The special responsibility of the United States for relief and rehabilitation has been recognized by both public opinion and our Government. This recognition is inspired not only by the fact that the Islands are technically United States soil, but by spontaneous and universal admiration for the heroic resistance and sacrifices of the Filipino people. President Roosevelt has pledged the country "to make the Philippines, as an independent nation, economically secure wherever possible," and Congress placed them under the protection of American war risk insurance in the Spring of 1942.

To speed rehabilitation, a Congressional Act of last June created the Philippine Rehabilitation Commission, composed of nine American and nine Filipino members. The first business meeting was held last month under the chairmanship of Senator Tydings of Maryland, who as one of the sponsors of the Independence Act of 1934 has long been acquainted with the problems of the Islands. The Commission is charged:

> To investigate all matters affecting postwar economy, trade, finance, economic stability, and rehabilitation of the Islands, including the matter of damages to public and private property and to persons occasioned by enemy attack and occupation.
>
> To formulate recommendations based upon such investigations and for future trade relations between the United States and the independent Philippine Republic when established and to consider the extension of the present or heretofore agreed upon trade relations or otherwise for a period of years to make adjustments for the period of occupancy by the Japanese in order to reestablish trade relations as provided for in the original Independence Act.

Immediate relief, especially in the form of food and medical supplies, is being provided by the U. S. Army. Damage to property was severe even before the bitter struggle in Manila took place. The equipment of many industrial plants was dismantled and shipped to Japan. Inter-island shipping facilities are probably almost a total loss.

Which Way Reconstruction?

While the rendering of immediate relief may be taken for granted, and payment of war damages can be speeded by Congressional action, the problem of economic reconstruction of the coming Filipino Republic is a complex matter. What course should it take? Should the Islands be developed around the products which made them prosperous in the past? If so, can new markets be found for these products, assuming that the United States, under the provisions of the Independence Act, applies tariffs which might close our market to many of them? Or is there a possibility of new arrangements with the United States which for a stated time will permit imports free or without prohibitive duties?

Alternatively, should the Islands be developed so as to be independent of the American market, possibly aiming to sell principally within the Far East? If so, will it be possible to develop new export commodities at a time when world markets may be dislocated and the purchasing power of surrounding countries low? Where will the necessary capital come from for industrialization of the Islands? Will they be able to carry on during the presumably long period required for development of new industries and export crops?

Past Dependence Upon American Market

The past dependence of the Philippine economy on the United States is generally known and requires but brief review. During the first ten years of the United States tutelage (1899-1908), combined exports and imports averaged about $57 million a year, trade with the United States amounting to about $14 million. In 1909 Congress enacted the first reciprocal

free trade agreement; and from 1913 to 1935 all Philippine products had free entry to the United States market and vice versa. During the ten-year period, 1926-35, the average annual value of Philippine commerce was $231 million, of which 71 per cent was with the United States.

The expansion of exports was greatest in commodities which enjoyed the protection of American tariffs levied on products from other sources of supply. Exports of sugar rose from about 80,000 short tons in the 1899-1902 period to over 1,000,000 tons in the 1932-35 period, accounting for over 50 per cent of total exports. Exports of coconut oil were built up from practically nothing to almost 190,000 tons in 1935. Of the important export commodities, only raw hemp (abaca) and copra, which accounted for about 16 per cent of total exports in 1932-35, enjoyed no tariff protection. inasmuch as they were on the U. S. free list for all countries.

The establishment of free trade stimulated investment in the principal industries and in the Islands in general. About $734 million was invested in the sugar, coconut and abaca (hemp) industries, of which $607 million represented Filipino investments, mostly land and improvements, and $63 million American investments, mostly in mills and equipment. These three industries, as will be seen from the table below, provided livelihood for some 8½ million people or over one-half of the total population. Total American investments were estimated in 1938 at $260 million, which was about 60 per cent of the foreign capital placed in the Islands.

Concentration of agricultural production in a relatively few cash crops retarded the diversification of agriculture, and even during the transition period (1936-1940) nearly 20 per cent of the imports consisted of food products, many of which could have been produced at home. But the relatively large cash income resulted in a standard of living which was estimated to be about three times as high as that of the surrounding tropical countries.

The Philippines were the sixth largest importer of American goods in the 1936-40 period. Machinery, motor vehicles, and steel products constituted the largest imports averaging about $27 million a year. The Islands were our best customer for cotton goods, evaporated milk, dynamite, and cigarettes. Some 97 per cent of our exports consisted of products subject to Philippine tariffs, which under the free trade agreement were waived.

The Provisions of the Independence Act

Under the revised Independence Bill passed in 1934, the period afforded to the Philippine Islands in which to make the adjustment from their dependence on the American free market to world markets was ten and a half years. Duty-free imports into the U. S. of sugar, coconut oil and hemp cordage were limited to stated quotas. Beginning with the fifth year of the period, the Island Government was directed to impose an export tax, equalling 5 per cent of the American tariff, on all exports except those on our free list. This tax was to be raised each year until by 1945 Philippine goods were to be subject to 25 per cent of the regular American duty. At the same time, however, the Commonwealth Government was not empowered to take any tariff action against imports from the United States.

It soon became apparent that many of the industries would not be able to survive the imposition of the export tax. The Tariff Commission, which was then one of several Government agencies studying Philippine problems, reported that "it is not at all certain that adequate provisions have been made for a transition sufficiently gradual . . . and a number of important enterprises in the Islands may be forced to liquidate more rapidly than new enterprises can be developed to replace them." Following President Quezon's visit to Washington in 1937, a "Joint Preparatory Committee" was appointed to investigate the economic situation. In 1938 the Committee submitted a report, hailed by the Filipinos, which recommended that the period of adjustment of preferential trade relations between the United States and the Philippines be extended until 1960. It also urged that the pressure of export taxes on certain industries be eased by substitution of duty-free quotas, di-

Selected Statistics of Philippine Industries
(All Dollar Figures in Millions)

	Investments (Pre-war) Total	Filipino	American	Foreign	Exports 1936-40 Ave.(a) Total	to U.S.	Tax Collections (b)	People Dependent
Sugar (and products) industry	$305	$234	$40	$30	$53	$53	$10.0	2,000,000
Coconut (and products) industry	221	196	14	11	34	27	3.8	4,000,000
Abaca (hemp) and cordage industry	208	177	9	22	16	5	1.0	2,500,000
Tobacco (and products) industry	30	20	(c)	10	6	3	4.3	500,000
Mining and minerals	(d)	(d)	70	12	30	27	3.6	(e)
Embroideries	8	1	7	....	5	5	(d)	150,000
Lumber and timber	15	5	6	4	3	1	(d)	420,000

(a) Including gold and silver. (b) Various dates. (c) Included in foreign. (d) Not available. (e) Direct employment 40,000.

minishing each year, and proposed that the Philippine Government should begin to levy a duty on United States imports, starting with 25 per cent of the regular duty in 1946.

Only a part of the recommendations of the Committee were embodied in the Amendment to the Independence Act, passed in August 1939. Four principal industries (exclusive of sugar and cordage) were exempted from an export tax and put on the diminishing quota basis. The recommendation that the readjustment period should be extended to 1960 was not acted on. The provision of the Independence Act calling for an economic conference to discuss post-independence trade relations was, however, strengthened and the date advanced to not later than 1944.

Interruption in the Adjustment Period

Though at the time of the Japanese attack the Philippines were in the sixth year of the ten-year period of transition, the accomplishments in the way of development of new markets or new commodities had not been encouraging. In 1940, the last full year for which data are available, the United States still took no less than 83 per cent of Philippine exports and supplied 78 per cent of the imports.

One reason for the slowness in the adjustments was the fear of a drastic reduction in the standard of living which the reduction in labor costs, necessary to enable the Philippines to compete with surrounding tropical areas, would have involved. Another reason was perhaps the persistent hope that the United States would ultimately reconsider some of the economic clauses of the Independence Act. Efforts were made to develop growing of cotton and other new agricultural products. In industrial development, a start was made with a cotton spinning and weaving mill (government owned) and encouragement was given to leather and shoe manufacturing, and to food processing and dairy industries.

Japanese occupation bore hard on such large export industries as sugar. Under normal conditions, many centrals would have been amortized by 1946 and would have had considerably lower production costs. But this development was upset by enemy occupation, and it is now argued that only the assurance of a long period of tariff preference will induce the owners to rebuild the sugar mills or to keep their capital in the Philippines. This applies equally or more to coconut oil refineries and cigar factories. Filipino members of the Rehabilitation Commission have proposed continuation of existing trade arrangements for twenty years.

Rehabilitation Plus Readjustment

Undoubtedly recovery will be slow and painful in the Philippines if, in addition to rehabilitation, the Commonwealth has to undertake a quick and full adjustment of its economy from a position of free access to the American market to a world market basis. A much more far-reaching shift in agricultural production than has been carried out thus far will be necessary. Similarly, if the standard of living is to be maintained near the pre-war level, there will have to be an equally far-reaching extension of light industries, which in turn would entail development of power facilities. This would require conditions conducive to imports of capital and investment.

Most opinion would probably hold that any country which is to enjoy full political freedom should also be independent economically. It is argued with much reason that the Philippines cannot establish a self-sustaining and lasting prosperity as long as their economy depends greatly upon a preferred position conferred by another sovereign nation. The haul halfway around the world of those Philippine products which the United States could obtain from short-haul sources — which preferential treatment leads to — is basically uneconomic.

On the other side of the question, however, it may be said that we are confronted by a condition, not a theory. The United States bears responsibility for initially fostering the development of the Islands under preferential economic arrangements, and has a moral responsibility to the Philippine people. The formulas included in the Independence Act for the termination of the economic arrangements may fairly be termed obsolete because of the intervention of the war, which has taken more than three years out of the ten-year transition period and has caused vast damage to productive facilities. These are forceful reasons for revision of the formulas to provide at least a new and adequate transition period. Finally, since we shall need Philippine air and naval bases for our own security in the Western Pacific, it would be in our interest to see to it that the areas in which these bases are located have political and social stability.

A determination of policy by the United States is urgently needed if private capital is to help in the rehabilitation and further development of the Islands. The Philippine Rehabilitation Commission is the agency empowered to study the various problems and conflicting interests, and to recommend the future pattern for trade between the two countries. The earlier such recommendations can be presented for public discussion and Congressional action, the sooner will property owners, investors and individual entrepreneurs be able to gauge the direction of future development, and the more effectively will rehabilitation be carried out. There may be alternative ways to attack the problem, but there is no escape from its urgency.

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